Minutes

Gas Transmission Charging Review (GTCR) Open Forum

Open Forum to discuss GTCR policy proposals (published 12/12/14) and accompanying assessment of impact (published 30/01/15) to help stakeholders respond to consultation closing 27 March 2015	From Date and time of Meeting Location	Alice Mitchell 25 February 2015 14.30 – 16.30 Ofgem, 9 Millbank London

1. Present

Ofgem:
Judith Ross (JR) – Head of Gas Transmission Policy
Alena Fielding (AF) - GTCR, Bogdan Kowalewicz, Alice Mitchell, Nathan Macwhinnie, Andrew Malley

Registered attendees:
Amrik Bal (Shell)
Anna Shrigley (Eni)
Andrew R Pearce (BP Gas Marketing)
Natasha Ranatunga (EDF Energy)
Colin Williams (NGG)
Colin Hamilton (NGG)
Debra Hawkin (consultant)
Dennis Rachwal (NGG)
Francisco Goncalves (Gazprom)
Gareth Davies (Statoil)
Gary Cole (Chevron)
Guy Hannay-Wilson (Chevron)
Isabelle Magne (GDF Suez) via teleconference
Jeff Chandler (SSE)
John Galbraith (Chevron)
Julie Cox (EnergyUK)
Kirsten Elliott-Smith (Cornwall Energy)Laura Butterfield (NGG)
Lee Bowerbank (Exxon Mobil) via teleconference
Lucy Manning (Interconnector UK)
Marshall Hall (OGUK)
Natasha Ranatunga (EDF)
Nick Wye (Waters Wye Associates Ltd)
Nicola Duffin (South Hook Gas)
Nigel Sisman (Sisman Energy Consultancy Ltd)
Pavanjit Dhesi (Interconnector UK)
Peter Biltoft-Jensen (Dong Energy)
Ricky Hill (Centrica Energy)
Ritchard Hewitt (NGG)
Roddy Monroe (Centrica Storage)
Samia Adel (STORENGY UK)
Tim Walls (Conoco Phillips)
Toby Hockin (BG Group)
Yousef Al-Ali (South Hook Gas)

2. Welcome

JR welcomed participants. She said that the Open Forum aimed to let the industry discuss and understand more about the Gas Transmission Charging Review (GTCR) policy proposals published in December 2014. These proposals are out for consultation, closing 27 March 2015. JR hoped the forum would help stakeholders formulate their consultation responses through explaining the Impact Assessment (IA) published 31 January 2015.

3. Presentation

AF gave a presentation summarising the key elements of the GTCR proposals and findings on the Impact Assessment published in December 2014 and January 2015 respectively. A copy of this presentation is available on our GTCR website: https://www.ofgem.gov.uk/publications-and-updates/gas-transmission-charging-review-open-forum-25-february-2015

Action: provide consultation response on our proposals supported by data and evidence where available. Responses can be confidential.	**All stakeholders 27 March 2015**

4. Q&A session

Stakeholders raised a wide range of issues. For the purposes of this record, we have grouped the questions and our answers into themes. Sentences marked with * provide additional clarification beyond the answers given on the day.

Proposal to move to fully-floating charges

What is wrong with the existing commodity charge arrangements? What are the merits of socialising TO (Transportation Owner) entry revenue under-recovery based on bookings instead of flows?

The existing regime is not completely broken – but it can be improved (which was noted by the industry stakeholders in their responses to our Call for Evidence in 2013). Currently, the recovery of NGG's (National Grid Gas) historical investment is socialised on the basis of flows. We think the more cost-reflective approach would be to socialise the investment based on bookings. This is because all users who are able to book capacity benefit from the existence of a reliable network, not just those who choose to flow gas. The network is available to everyone but not everyone is paying for its availability. Therefore, all those booking should contribute to the cost of providing the network.

Currently, those who flow more gas pay (sometimes disproportionally) more than those who don't – even though the historical cost being socialised is independent of flows. We believe that greater cost-reflectivity of charges better facilitates competition.

Our proposals for fully-floating stem from cost-reflectivity principles, and are designed to work in different contextual scenarios and remain robust when trends in shipper behaviour change.

Why make a big change for no discernible benefit?

As discussed above, we think the changes we propose are a step in the right direction. We are asking for more evidence to understand how big a change our proposals present to different shippers, and whether it is transitional or specifically detrimental to any one group.

Current system is a benefit because it is the current system.

We recognise that change has costs, and these should be weighed up before going ahead with any changes. However, the balance of probability is that some changes will be needed because of the European Tariff Code (TAR NC).

Isn't there a simpler solution? Did you consider modelling an increase in the QSEC (Quarterly System Entry Capacity) reserve price upfront? Could you change the model used to calculate charges? Would reducing the short term discounts – on its own – solve the problem of under-recovery?

Adjusting reserve prices ahead of time would be very similar in effect (increasing the cost of all booked capacity), but retrospective rather than upfront. Retrospective adjustment is likely to cope better with varying demand. One reason is that as less QSEC is being bought with more users buying short-term products, setting even higher reserve prices in advance might still not recover the allowed revenue without the need for a commodity charge adjustment.

We have modelled significant decreases to short-term capacity reserve discounts. However, the low demand effect dominates- even with no discount for short-term products, there still remains a significant gap in the allowed revenue to be recovered (our modelling shows that

even with lower discounts (at 30%) or without discounts at all (0% discount) the commodity charge still recovers 40% of allowed revenue).

Consider a hybrid-type system with some retained commodity element and some increase in the capacity charge – e.g. 40% floating component. This should have less effect on liquidity.

Earlier in 2014 we commissioned a literature review of theory and applied practice of network access charging. This was across industries, and across countries. In general, it appears that capacity-based charging regimes suit mature networks better.

We haven't seen any strong evidence supporting a particular hybrid arrangement. Our initial thoughts are that a hybrid system could be more unpredictable and complicated, with two sets of adjustments necessary, possibly twice a year (ongoing commodity charge and some floating). *The existing GB system is already a hybrid.

The potential impact on liquidity is discussed in the section "IA-specific questions" below.

Should the split of the allowed revenue between exit and entry be revisited? GTCR proposals will not result in stronger locational signals. Better solution would be to put more of the recovery burden on exit with stronger locations signals.

At the start of the GTCR, it was agreed that the scope of the review will focus on entry charging. Our initial thoughts are that this approach would only shift the problem of under-recovery to exit users. This could disproportionally affect the Distribution Networks who cannot avoid flowing, and would pick up the majority of the charge. In considering changes for the purposes of the GTCR, we have been mindful of scope creep, and focused on making changes within the boundaries of the draft European Tariff Code.

UKCS decline will shift users to short-term capacity.

The trend for booking short-term, rather than long-term capacity has been driven by a combination of a) increasing spare capacity on the network and b) a pricing structure of discounted short-term reserve prices and optional flow-based commodity charge. While we observe the trend now, it is unclear whether short-term booking will completely replace long-term bookings (existing QSEC bookings extend to 2029).

Our proposals are not intended to influence or change the balance individual shippers strike between long- and short-term bookings. Discussion of this aspect of the model is noted in the section 'IA-specific questions'.

*In the example of all users going short-term and booking capacity close to the level of flows, the level of costs they face should be the same, regardless of the regime. Even if bookings reduce, the flows still need to be at the level to meet the demand for gas.

Technical detail of the proposals

How often will the floating adjustment be made? TAR NC might impose different products at interconnection points (eg annual), which may require different periodic adjustments/limit the frequency of adjustment.

NGG currently adjust the commodity charge twice a year. This is our starting assumption for the adjustment frequency for the fully-floating charge. This is an implementation question, and should be discussed by the industry, once the relevant provisions of TAR NC are clear.

What will the clearing price be? Will it be reserve + premium?

Yes, the reserve price will be calculated the exactly as it is today (LRMC methodology). The auction premium will be added to produce the clearing price, and the top-up adjustment.

IA specific questions

Are the conclusions about price elasticity of demand for short-term capacity based on modelling or surveying? Is there explicit analysis of cross-price elasticity of demand for short-term and long-term capacity? Shippers will modify behaviour and book less of both long-term and short-term so need to take account of this in modelling.

Price elasticity of demand for capacity is a parameterised input within the model. That is, some types of shippers will respond differently to changes in entry charges. This is influenced by a number of factors, including the opportunity cost a shipper will face if they can't flow, level of congestion at their chosen entry point, opportunities for trading in other markets, etc.

Price responsiveness assumptions are important, and have been presented by our modelling consultants (CEPA[1] and TPA Solutions) and discussed with the industry at the GTCR technical workshops (Workshops II and III, 17 and 23 July 14 – details on our GTCR website). CEPA have asked for specific input on this, including:

> What factors do network users consider in practice when forming a booking strategy?
>
> Do you agree with our general proposed approach of determining short-term vs. long-term bookings under alternative tariffing arrangements?
>
> How should we determine the probability of a commercial constraint?

Price responsiveness modelling is discussed in detail in Annex A of the final model report, published on our GTCR website.

Based on the price responsiveness assumptions made in the model, the results have shown that as long as short-term capacity is priced at a discount from long-term capacity, the demand for short-term capacity is relatively inelastic to changes in the level of discounts, relative to the demand for long-term capacity. This high-level conclusion conforms to expectations – where a network is unconstrained and the risk of not obtaining capacity on the day is almost non-existent, a shipper is likely to choose the cheapest, most flexible product.

We know there are exceptions to this – eg shippers triggering incremental capacity have to buy QSEC. And there may be some variation in individual purchasing decisions of shippers – eg they may book closer to flows as the discounts change.

However, the model's aggregate outputs seem reasonable – the model already assumes that flows=bookings, so there is no scope for booking above flows.

We always welcome further evidence from the industry which can help us better understand the impacts of our policies.

How would reducing overbooking help NGG? Is there any evidence that this would improve operational efficiency?

From a regulator's perspective, our argument is that better information about how the NTS is used can promote better decision making by the network owner and operator. In recent years, the ratio of flows to bookings has been falling – over 2013/14 only 22.2% of

[1] Cambridge Economics Policy Associates

bookings were actually nominated for gas flows. Therefore, we wanted to raise this issue, as it suggests that the data on bookings isn't a true reflection on how the network is used – sending inaccurate locational signals and volumes.

Whether the information will bring the practical benefit is something for the industry, and especially NGG to comment on in their responses.

NGG noted that better information has a benefit to the regime as a whole, to NGG or to other parties. The extent of the benefit will depend on the detail of the proposals.

The proposals will increase entry costs - this is an additional transaction cost in gas trade. This will negatively affect NBP[2] liquidity.

Ofgem would welcome analysis and further rationale to substantiate the argument that our proposed measures would negatively affect NBP liquidity.

The assertion that our proposals would uniformly increase entry costs is not correct – as the allowed revenue would remain the same. The impact on individual shippers would be influenced by their capacity booking strategies.

Finally, parties engage in NBP trading for a number of reasons. Interconnector and storage arbitrage flows are important to GB security of supply. However, the proportion of these trades is small compared to the total volume of trade at the NBP. Therefore, we think it unlikely that the NBP liquidity would be materially affected by our proposals.

We understand in principle the argument made about the impact on liquidity. In order for us to consider this further in our decision, we will need quantitative evidence demonstrating a detrimental impact.

If costs at Bacton are unknown (due to unknown floating adjustment) then this will disincentivise cross border flows. If you introduce uncertainty market, liquidity could dry up if the prices are unknown at NBP.

The commodity charge is currently an unknown adjustment so this risk isn't new.

The proposals will create an environment where no change in behaviour will occur. This will create 2 classes of shippers: those who can take advantage of short-term capacity and those who can't (where NGG require shippers wanting incremental capacity to make 8 year bookings). This could also be discriminatory to new entrants who need incremental for new connection. You may have to revisit the NPV test, as those who have bought capacity are locked in.

Our changes are not directly aimed at changing behaviour. We want to understand the impacts described better, and welcome confidential responses from the network users affected. We are happy to meet and discuss at any time.

Will there be a cost benefit analysis of your proposals?

The allowed revenue will stay the same. The impact of our proposals is distributional – which we have considered in our January document. We have not identified material spill-over effects of our proposed changes. Therefore, the system wide impact is likely to be neutral, and we don't see merit in carrying out further cost-benefit analysis.

[2] The National Balancing Point, commonly referred to as the NBP, is a virtual trading location for the sale and purchase and exchange of UK natural gas.

There will be an impact on cross border flows at interconnection points if there is preferential treatment for storage operators by not requiring them to pay floating charges.

Our proposals maintain the current principle where storage users don't pay commodity charges. In any case, when we looked at the model results for revenue recovery by supply source, they were broadly similar under both the current and proposed charging regimes. Our modelling also showed that applying fully-floating charges to storage users would have a limited effect on the charges paid by all other users.

In year 1 of implementation, the floating adjustment would need to be based on forecasts for revenue from short-term bookings. Any over- or under-recovery would then need to be accounted for in year 2, and so on. This carry forward will increase volatility.

It is not immediately clear to us why volatility would increase under fully-floating arrangements. This would depend on the ability of NGG to forecast bookings, and whether there are reasons why forecasting bookings is more complex/prone to volatility than forecasting flows for the purposes of calculating the commodity charge.

Tariffs Network Code (TAR NC) interactions

If TAR NC requires a different split of TO/SO[3] revenues, this might mean that more revenue would need to be recovered via the TO charge. Is this one of the 16 issues to be resolved as part of the comitology process? What is our opinion of where this will end up in Europe?

This is not one of the 16 issues, GB is the only Member State affected by this. From the GTCR perspective, we do not have an opinion on this – we know work is ongoing to develop solutions to this issue, involving Ofgem and NGG.

The split would change the amount to be recovered. Our proposals are aimed at the distribution of a given amount of revenue to be recovered. Therefore, the outcome of TAR NC would provide an input to GTCR, but the TO/SO split issue doesn't affect the principles of our proposals. *If the revenue is re-allocated and TO charges increase, the SO charges would decrease – as the allowed revenue is set under RIIO-T1.

CAM means that capacity at Bacton IP will be bundled in annual products, not quarterly as QSEC. How will this be accommodated in the GTCR proposals?

This is an issue for implementation, once TAR NC is settled. The annual product would need to be accommodated in the GB regime even without the GTCR changes.

We want to keep the option to retain the existing commodity charge regime.

We have been continuously challenged in EU meetings to provide policy justifications for keeping a different regime. Our conclusion following the Review is that a regime with fully-floating charges would be an improvement on the current regime. Our policy position, with an expressed preference for floating charges, is public on our website.

Next steps

What are the next steps – will there be any more analysis?

We plan to publish our decision following consideration of consultation responses in the summer. It is likely we would hold a similar event to today's around then. As we said in January, any changes won't be implemented until TAR NC comes into force, which is currently timetabled for October 2017.

[3] Transportation Owner/System Operator

Will it be an initial decision? How can it be finalised before the substance of TAR is known? There could be implications of TAR that mean the GTCR proposals aren't compatible? TAR could be delayed due to discussions over TO/SO split.

Our GTCR proposals are a policy position on the principles of charging. We have considered the developing legislation throughout this process, and will continue to monitor the development of TAR NC. We will consider the scope and scale of needed adjustments once TAR NC is more settled.

The compatibility of GB regime with TAR NC will continue to be an issue with, or without the GTCR changes.

5. Future GTCR stakeholder engagement

5.1. The consultation closes 27 March 2015. For more information on the consultation questions, please see the Policy Position and the Impact Assessment available on our GTCR website https://www.ofgem.gov.uk/gas/transmission-networks/gas-transmission-charging-review

5.2. We aim to publish our policy decision in the summer, taking into account the consultation responses.

5.3. We will hold a further Open Forum event before this is published to explain our decision to stakeholders.